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FIRST MONETARY POLICY REPORT
FOR 1983

FROM THE

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

FIRST SESSION

A REPORT

together with

ADDITIONAL VIEWS

SUBMITTED PURSUANT TO PUBLIC LAW 95-523



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LETTER OF TRANSMITTAL

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., March 22, 1983.

Hon. GEORGE BUSH,
President of the U.S. Senate,
Washington, D.C.

DEAR MR. PRESIDENT: Transmitted herewith is the First Monetary Policy Report for 1983 on the Conduct of Monetary Policy, pursuant to Public Law 95-523 and oversight hearings held on February 16, 18, and 22, 1983.

Sincerely yours,

JAKE GARN, *Chairman.*

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FIRST MONETARY POLICY REPORT FOR 1983

On February 16, 1983, the Committee on Banking, Housing and Urban Affairs received this year's first "Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978" (Public Law 95-523) from the Board of Governors of the Federal Reserve System.

Three days of hearings on the Report and on monetary policy were held by the Committee. On February 16, 1983, Federal Reserve Board Chairman Paul A. Volcker presented a statement and testimony to the Committee. On February 18, 1983, statements and testimony were received from Martin Feldstein, Chairman, the President's Council of Economic Advisers; Andrew F. Brimmer, President, Brimmer & Company; John D. Paulus, Chief Economist, Morgan Stanley & Company; and J. Richard Zecker, Chief Economist, Chase Manhattan Bank.

On February 22, 1983, Beryl Sprinkel, Department of the Treasury, Under Secretary for Monetary Affairs, appeared before the Committee.

MONETARY GROWTH

Growth in the M-1 monetary aggregate accelerated sharply in the latter half of 1982. As noted by Secretary Sprinkel, during the last quarter of the year, M-1 grew at an annual compound rate of nearly 14 percent. For the year as a whole, M-1 grew 8.5 percent, substantially more than the originally targeted growth of 2.5 percent to 5.5 percent.

M-2 and M-3 also exceeded the 1982 growth targets which had been set for them by the Federal Open Market Committee, but not by nearly as much as M-1. During January of 1983, however, M-2's growth soared to a 30 percent annual rate.

For the four monetary aggregates whose growth rates were targeted in 1982, Table I compares the targets with actual growth.

TABLE I

Aggregate	1982 target range (percent)	1982 actual (percent)
M-1.....	2.5 to 5.5.....	8.5
M-2.....	6.0 to 9.0.....	9.2
M-3.....	6.5 to 9.5.....	10.1
Bank credit.....	6.0 to 9.0.....	7.1

Secretary Sprinkel told the Committee that:

... the monetary surge can be viewed as an abrupt and belated adjustment for the previous, prolonged undershooting. The rapid pace of money growth in recent months, in

fact, brought the fourth-quarter, 1982 average of M-1 up to the level that was implied by the Administration's originally recommended path for prudent non-inflationary monetary policy.

DEMAND FOR MONEY AND VELOCITY

The surge in the money supply that occurred during the latter part of 1982 was not accompanied by a similar increase in spending in the economy. Thus, for some reason(s), the public desired (or was willing) to hold larger money balances relative to the level of income in the economy.

The increased holdings of the assets that constitute the monetary aggregates relative to the level of economic activity was manifested in an atypical decline in monetary velocity, the reciprocal of the demand for money. As Mr. Volcker pointed out:

... the velocity of M-1, which had been trending higher throughout the postwar period, dropped at a rate of almost 4 percent over the past five quarters.

Or, as Mr. Feldstein told the Committee:

... many of the old verities of monetary economics no longer appear to be valid. For more than two decades, the ratio of the money stock to nominal GNP moved only within narrow bands. Last year, however, this "velocity" ratio declined sharply, leaving nominal GNP about six percent lower than might have been anticipated on the basis of the money stock.

FACTORS IMPACTING VELOCITY

A major focus of the testimony before the Committee was on the reason(s) behind the increase in the demand for money relative to the level of income and the associated decline in velocity.

Chairman Volcker's explanation pointed to a greater preference for highly liquid assets as a precautionary response to economic uncertainty. The Chairman also pointed to structural changes:

The maturity of a large volume of All Savers certificates in October temporarily led to large flows into transactions balances counted in M-1. Subsequently, highly aggressive marketing of new 'money market deposit accounts' by banks and thrift institutions led to enormous inflows into the highly liquid instrument, which is classified within the M-2 aggregates.

Mr. Paulus stressed these same structural changes as the reason for above-target growth in the aggregates:

... much of the growth in M-1 was due not to a build up of transactions balances (i.e. money to be spent), but to an inflow of investment funds into M-1 ... inflows of nontransactions balances (such as maturing all-savers certificates being rolled into NOW accounts and savings monies moving into NOWs).

Similarly, Mr. Paulus ascribed M-2's performance in January to structural change:

The outsized growth of M-2 in January . . . was largely attributable to a massive inflow of funds into the new money market accounts . . . from financial assets not included in M-2.

Mr. Brimmer joined Chairman Volcker in explaining the increased demand for money in terms of both structural change and uncertainty:

. . . the expansion in the monetary aggregates . . . reflected a number of dramatic innovations in the financial system. For example, the expiration of All Savers certificates led many households to place the proceeds—at least temporarily—in their checking accounts. The rapid deregulation of ceilings on interest rates payable by financial institutions was matched by the proliferation of a variety of high yielding deposit accounts . . .

Moreover, the high level of unemployment, strains in the financial system, and general uncertainty associated with the long recession, all combined to expand the public's demand for liquidity.

Chairman Feldstein attributed the initial decline in velocity more directly to last year's declining interest rates:

The Federal Reserve has explained that the termination of All Savers certificates was responsible for some of the abnormal increase (in money demand), since the funds from the All Savers certificates were temporarily held in M-1 accounts. Even more important, I believe, was the reaction of M-1 demand to the sharp decline in interest rates.

Mr. Feldstein also pointed to structural changes to explain continuing declines in velocity late last year and early in 1983:

The major changes in banking regulation that went into effect in December and January—the money market deposit accounts and the super-NOW accounts—have introduced a new and substantial source of temporary instability in the relationship between the monetary aggregates and nominal GNP.

ALTERNATIVE TO MONEY GROWTH

According to Chairman Volcker, whatever the reason for last fall's increase in the public's demand for monetary aggregates, if the Federal Reserve had attempted to keep their growth rates within the targets, the result would have been an excessively restrictive monetary policy:

. . . "above target" growth was accommodated in the conviction that policy, in practical effect, would otherwise have been appreciably more restrictive than intended in setting the targets.

Mr. Zecker did not disagree:

... money growth since last summer has been very rapid. Given the events of this period, the Fed was faced with two choices: (a) accommodate this rapid expansion of monetary aggregates by generating the required growth in the monetary base or (b) apply the monetary brakes again, slowing growth in the aggregates but, in the process, causing another interest-rate cycle.

Mr. Brimmer also concurred:

If the Federal Reserve had attempted to force the growth rates of the monetary aggregates back into the target ranges adopted in early 1982, the necessary restraint on bank reserves would have been so great that the economy would have been pushed even more deeply into recession. . . .

INTEREST RATES

As already noted in a quote from Chairman Feldstein, 1982 brought a "sharp decline in interest rates." Most importantly, Secretary Sprinkel told the Committee that the timing of the decline in rates showed that it was not attributable to the acceleration in money growth:

While it is widely believed that the decline in interest rates that occurred last summer was the result of a more accommodative Federal Reserve policy, this is not really an accurate portrayal of the timing of events. Money growth began to accelerate in August and . . . most of the decline in interest rates had already occurred by August.

Moreover, as Mr. Sprinkel also pointed out, rapid money growth during the fall was associated with some reversal of the decline in interest rates:

Some short-term rates are now slightly lower than they were in late August, but the three-month Treasury bill rate is higher now than it was the last week in August. The decline in long-term rates continued into the fall, but then leveled off; long-term rates have risen slightly in the last few months.

Chairman Volcker pointed to prospective federal deficits as a factor impeding further interest rate declines, but he stressed continuing fears of a resurgence of inflation:

Today, short and particularly longer-term interest rates, despite the large declines last year, remain historically high in nominal terms as measured against the *current* rate of inflation. A number of factors contribute to that, including the present and prospective pressures from heavy Treasury borrowing. But concerns that recent gains against inflation may prove temporary are checking the decline in interest rates.

Chairman Feldstein put the stress on prospective federal deficits as the cause of continuing high interest rates:

The primary cause of the high real interest rates is the very large budget deficits that still hang as a cloud over the economy for the entire decade of the 1980's.

However, Mr. Feldstein cautioned Congress against dropping tax indexing as a way to bring down prospective deficits:

... the idea of reducing the budget deficit by eliminating (or "postponing") the indexing of tax brackets would be counterproductive. Everyone would soon recognize that deindexing the tax law would produce relatively little additional revenue if the inflation rate was low but a great deal of extra revenue if inflation is high. Deindexing the tax law would produce a powerful incentive for Congress to force the Fed to follow an inflationary monetary policy. I believe that the immediate effect of deindexing the tax law would be a rise in long-term interest rates and a weakening of the recovery.

1983 TARGETS

While Chairman Volcker argued that special factors justified above-target growth in the monetary aggregates last year, he again stressed that, over the long term:

... success in dealing with inflation requires appropriate restraint on growth of money and liquidity.

At the same time, Mr. Volcker noted the impossibility of knowing whether the period of atypical behavior in velocity is ending:

... the Federal Reserve has had no choice but to take into account the fact that "normal" past relationships between money and the economy did not hold in 1982, and may be in the process of continuing change. ...

Chairman Feldstein stressed the same need for balance between these long-term and short-term considerations:

Monetary policy at the present time cannot be guided by applying mechanical rules. The Federal Reserve must use its judgment to adjust the money stock during the present temporary period of transition while asset demands are adjusting to the new regulatory arrangements. But it must also be clear that, when the transition is finished, the Fed will return to the sound and disciplined rules for controlling the growth of the money stock in a way that permits nominal GNP growth at a rate that is consistent with sustainable growth of real GNP and a moderating rate of inflation.

In implementing monetary policy during coming months, Mr. Volcker announced that more focus would be placed on the M-2 and M-3 aggregates because their velocities appeared likely to be more predictable:

Both declining rates of inflation and the growing availability of interest on transactions accounts at levels competitive to market rates could induce more holdings of cash relative to other assets over time . . . The broader ag-

gregates, by their nature, should be less sensitive over time to innovation since they encompass a much broader range of assets. . . .

Table II compares the Federal Reserve's 1983 targets for growth in the monetary aggregates with the 1982 targets. The broadened range for M-1 growth reflects the uncertainty over the future course of M-1 velocity.

TABLE II

Aggregate	1982 target range (percent)	1983 target range (percent)
M-1	2.5 to 5.5	4.0 to 8.0.
M-2	6.0 to 9.0	7.0 to 10.0.
M-3	6.5 to 9.5	6.5 to 9.5.
Total credit	NA	8.5 to 11.5.

NA: Not available.

Two important changes were made in the targeting format. First, the base for M-2 growth was made the February-March average of this year instead of the fourth-quarter average for 1982. Second, a growth range was announced for "total credit" instead of just for "bank credit."

February-March was chosen as the base for M-2 in light of an expectation that the continuing rapid movement of funds into the newly-available market rate deposit accounts "will have sharply subsided in coming weeks." Still, to allow for some continued movement over the course of the year, the 1983 target growth range for M-2 was raised one percentage point from 1982's.

Chairman Volcker characterized the range for the "total credit" aggregate, not as a "target", but as a range of "expectations." He said this was necessary because:

Data for such a broad credit aggregate are not yet available monthly, nor are tools available to influence closely total flows of credit.

EVALUATION OF 1983 TARGETS

Secretary Sprinkel cautioned that a continuation of rapid money growth could not be used to achieve further declines in interest rates:

. . . While the rapid growth of bank reserves provided by the Federal Reserve in recent months did push short-term interest rates down to some extent, attempts to continue to do so are likely to be self-defeating. We have already seen a levelling off of short-term rates despite continued rapid reserve and money growth; the last two decreases in the discount rate have not elicited similar decreases in short-term market rates.

Even more to the point, Mr. Sprinkel argued:

The uptick in long-term rates in recent months may be the first signal that, from the viewpoint of the financial markets, the monetary expansion has gone too far.

At the same time, Mr. Sprinkel did not advocate draining money from the system to offset rapid growth during the fall:

It would be ill-advised for the Federal Reserve to attempt to reverse the bulge in money that has occurred in the last few months.

On balance, Mr. Sprinkel approved of the new growth targets announced by Chairman Volcker for the monetary aggregates:

The money growth target ranges for 1983 . . . are consistent with our goal of providing enough money to support the expansion, without reigniting inflationary pressures.

Chairman Feldstein also approved of the Federal Reserve's stated objectives:

I believe that the procedure for 1983 that Chairman Volcker announced earlier this week is commendable. It recognizes the fundamental uncertainty about the shifts in money stocks during the first quarter of the year but then returns to the discipline implied by the target rates of money growth.

CONCLUSIONS

Pursuant to the requirement in the Full Employment and Balanced Growth Act for a report to the Senate by the Committee on Banking, Housing and Urban Affairs stating its "views and recommendations" regarding the Federal Reserve's Monetary Policy Report, the Committee finds:

1. The rapid growth in the monetary aggregates which has occurred since the Committee's "Second Monetary Policy Report for 1982" was the result, at least initially, of Federal Reserve accommodation of an increase in the demand for money balances relative to the level of income. Several factors may have accounted for this increase in the demand for money or decline in velocity: the sharp drop in interest rates beginning in June, the maturing of a large volume of All Savers certificates in October, the popularity of new market-rate deposit instruments that first became available in December and an increase in precautionary balances attributable to economic uncertainty.

In this regard, the Committee reminds the Federal Reserve of one of the Conclusions from the Committee's First Monetary Policy Report for 1981:

If unanticipated financial developments mandate a change in the target growth rates, the Federal Open Market Committee should announce its new targets with an immediate explanation to Congress and the American people rather than leave the old targets in place and allow the aggregates to diverge from them.

2. The sharp decline in interest rates which occurred in 1982 was not attributable to the acceleration in the monetary aggregates' growth rates during the fall. To the contrary, most of the decline in Treasury rates—the best indicator of financial market psycholo-

gy—preceded the acceleration in the monetary growth rates. The Committee received testimony, in fact, that the continuation of rapid money growth through the end of the year was responsible for some reversal of earlier interest rate declines as the speed of the money growth began to revive inflationary fears.

3. While real interest rates are unmeasurable because they depend on expectations of future inflation and these cannot be calculated, it is clear that nominal rates remain unusually high, by historical standards, relative to current inflation rates. The current outlook for continuation of exceptionally large federal budget deficits, by historical standards, throughout the emerging period of economic expansion appears to be the major reason for the failure of interest rates to decline as quickly as inflation. Congress could make a major contribution to the lowering of interest rates by taking responsible steps to reduce prospective federal deficits.

4. The Federal Reserve's money-growth targets for 1983, if adhered to, should accommodate currently-anticipated structural changes in financial markets and also accommodate healthy economic expansion. Congress should not attempt to lower interest rates by putting political pressure on the Federal Reserve to go beyond accommodating structural changes in the demand for money to try to force rates down with faster money growth, for this likely would be counterproductive. Previous monetary policy reports from the Committee have concluded that our experience with interest-rate targeting by the Federal Reserve argues strongly against returning to such a policy.

As already stated, the role of Congress in lowering interest rates should be to take responsible steps to lower prospective federal deficits.

ADDITIONAL VIEWS OF SENATOR PROXMIRE

I believe the Fed may need to follow a somewhat more accommodative policy in 1983, especially if the demand for money continues to increase as it did throughout 1982. I also believe real interest rates are far too high to promote a vigorous economic recovery. But it would be a serious mistake if the Federal Reserve were to adopt explicit interest rate targets as its primary objective for monetary policy. Attempting to control interest rates irrespective of money growth can only lead to a resurgence of inflation.

Interest rates remain high by historical standards primarily because of the size of the federal budget deficit, especially in future years. CBO projections show the so-called structural deficits will increase from \$23 billion in 1982 to \$215 in fiscal year 1988 under current tax and spending policies. The structural deficit is the gap between revenues and expenditures assuming a 6 percent rate of unemployment. As a percent of GNP, the structural deficit would expand from less than 1 percent of GNP in 1982 to over 4 percent by 1988. This means the federal government will be competing more strongly every year for credit with the private sector, thereby driving up interest rates and pre-empting credit that could have been used for productive investments in the private economy.

President Reagan notwithstanding, the projected structural budget deficits are not a legacy of past policy errors over the last 20 years. Rather, the structural imbalance between revenues and expenditures stems primarily from the President's own economic program developed early in his Administration and largely adopted by the Congress in the summer of 1981. The President was able to sell the country, and for a time the Congress, that we really could have a rapid defense buildup, a sharp cut in taxes and only modest cuts in domestic programs without hurting the "truly needy", while at the same time balancing the federal budget—if not by 1984 then soon thereafter.

By now it has become painfully obvious that the President's numbers just didn't add up. We have a permanent budget deficit and it will get bigger every year both in absolute dollars and relative to GNP, even if we could somehow get to 6 percent unemployment which the President's own economic advisers are forecasting will not occur until late in the decade, if ever.

Reducing the budget deficit will require some painful and politically unpopular decisions. It is therefore natural that elected government officials tend to postpone these hard decisions until they are forced to make them by external forces.

One of the ways in which the private market signals its skepticism of the government's economic stewardship is through interest rates. Revenue and spending estimates that don't add up are ultimately reflected in higher interest rates as the market anticipates the crowding out effect of runaway deficit spending. Interest rates

therefore serve as a check on the natural propensity of politicians for self delusion.

If the Federal Reserve were to begin targeting interest rates this important check on governmental irresponsibility would be undermined. There would be a tendency for both the President and the Congress to weaken their efforts towards closing budget deficits.

The Federal Reserve would become a convenient scapegoat to be blamed for the high interest rates resulting from a burgeoning federal deficit.

This is not to say that the Federal Reserve should return to a rigid policy of controlling money growth irrespective of declines in money velocity or other economic developments. In retrospect, it is clear that the Federal Reserve was too restrictive during the first half of 1982, thereby deepening and prolonging the worst recession in 40 years. I am therefore encouraged that the Federal Reserve seems to be adopting a more flexible approach for controlling money growth in 1983. I encourage the Federal Reserve to maintain this flexibility and to resist pressures from monetarist economists to return to a fixed and rigid rule for managing money growth.

BILL PROXMIRE.

ADDITIONAL MINORITY VIEWS OF SENATORS CRANSTON, RIEGLE, SARBANES, SASSER, AND LAUTENBERG

We do not believe the monetary policy announced by the Federal Reserve represents a sufficient commitment for achieving the economic growth so desperately needed by our economy and its 12 million jobless workers. Putting aside all the confusion over the definitions of money and changes in velocity, Chairman Volcker revealed the FED's basic policy when he departed from his prepared text and said that "Money in all its various definitions *should grow less this year than last . . .*" [emphasis supplied].

In other words, the Federal Reserve is prepared to tighten its policy following the nation's worst recession in nearly half a century. The FED's policy increases the likelihood of an anemic recovery and stagnant growth over the foreseeable future, thereby consigning millions of Americans to the economic scrap-heap and sacrificing hundreds of billions of dollars in lost production.

The restrictive policies of the Federal Reserve are fully supported by the Reagan Administration which estimates that the Administration's program along with the FED's policy will produce real economic growth of 3 percent in 1983 and 4 percent thereafter. According to the Administration's economic game-plan, unemployment will still average more than 8 percent by the end of 1986. Given the normal increase in the labor force, this means that there will still be nearly ten million jobless Americans four years from now, about 2.5 million more than when President Reagan took office.

Even this dismal "growth" scenario may not be realized unless the Federal Reserve acts vigorously to reduce real interest rates from their historically high levels. As soon as the economy shows signs of recovery, the FED's announced tighter money policy is likely to sent interest rates higher thereby choking off further growth and sending the economy into another tailspin.

The policy of targeting money supply growth rather than interest rates was first established by the Federal Reserve in October of 1979. At the time, the FED's procedural shift was widely heralded as a long overdue change needed to get inflation under control.

Inflation was indeed reduced, but only at the cost of essentially stagnant economic growth over the last three years as indicated on the following table:

ANNUAL RATE OF REAL GNP GROWTH COMPARED TO THE QUARTER IN THE PRECEDING YEAR

Year	Quarter			
	I	II	III	IV
1979.....	5.2	2.2	2.6	1.4
1980.....	1.5	-0.8	-1.5	-0.7
1981.....	0.9	3.0	3.2	0.7
1982.....	-2.5	-1.6	-2.1	-1.2

After the new FED procedure was announced, there followed a five quarter period during which real economic growth first dropped sharply and then became negative. A feeble recovery began in the first quarter of 1981 and reached a high point in the third quarter when real growth averaged 3.2 percent. However, the FED's tight money policy which resulted in escalating interest rates stopped the recovery in its tracks. Growth plunged in the fourth quarter and remained negative throughout all of 1982.

Had the Federal Reserve been less rigid in attempting to target the growth of money, the current recession would not be as deep or as prolonged as it is. Targeting a particular definition of money, such as M-1, presumes there is a stable and predictable relationship between the amount of money and the level of economic activity. That relationship, known as velocity, has been fairly predictable in the past. Over the last twenty years M-1 velocity increased at an annual average rate of 3 percent, reflecting gradual improvements in cash management.

However, M-1 velocity dropped sharply starting in the first quarter of 1982 and continued to decline throughout the year. By the end of the year, M-1 velocity registered a 5 percent drop, the largest ever recorded. While there is no clear explanation of exactly why velocity dropped so precipitously, most economists believe it was due to an increased desire for liquidity brought about by economic uncertainty.

In any event, the Federal Reserve was late in responding to this sharp and unprecedented drop in velocity. During the first half of 1982, the FED stubbornly attempted to not to exceed the upper limit of its 5.5 percent growth target for M-1, which was set on the assumption velocity would increase from 1½ to 2 percent. Instead, velocity dropped by nearly 4 percent while M-1 growth was limited to 5 percent. With the sharp drop in velocity, the 5 percent increase in M-1 in the first half of 1982 was far more restrictive than the Federal Reserve had intended when the targets were initially set.

By the time the Federal Reserve shifted gears in July, it was too late. The economy was in the midst of the deepest recession since the 1930's. While the FED relaxed its grip on money growth during the last half of the year, these actions were not sufficient to arrest the economy's prolonged decline.

Looking at the year in retrospect, one is struck by the huge disparity between the FED's initial projections presented to the Committee last February and what actually happened.

—The FED projected M-1 to grow at a maximum of 5.5 percent; instead, it grew by 8.5 percent;

- The FED believed nominal GNP would grow around 9 percent; instead, it grew only 3 percent;
- The FED thought real GNP would grow about 2 percent; instead, it declined by 1 percent;
- The FED estimated inflation would increase by 7 percent; instead, it grew less than 5 percent;
- The FED anticipated that unemployment would reach 9 percent by the end of the year; instead, it hit 10.7 percent.

We believe one reason why the economy slumped so badly in 1982 was the inconsistency between the Federal Reserve's initial monetary targets and the increased demand for cash balances by the public. The FED failed to respond quickly enough to accommodate this increased demand, apparently because it was committed to the sanctity of its original M-1 targets.

In the past, money growth may have served as a more or less reliable guide for measuring the effect of monetary policy on the economy. However, with the substantial deregulation of the banking industry, the proliferation of new types of deposit accounts, the growing ability of the public to shift funds between different types of accounts, the changing definitions of money, and the unpredictable shifts in demand for liquidity that have occurred in recent years, firm targets for the monetary aggregates are no longer meaningful. As the experience of 1982 shows, figures on money growth can send signals that are at times dangerously misleading about the real effects of monetary policy.

We were encouraged by the Federal Reserve's decision, however belated, to suspend its monetary targets in response to changing economic circumstances. Moreover, the monetary targets established for 1983 seem to imply a more flexible approach that would depend upon subsequent developments. Nonetheless, we are concerned that the FED has not completely abandoned its monetarist ideology and that it might still return to rigid targeting at the first opportunity before the recovery even gets off the ground. There is no evidence the FED has shown any commitment towards getting interest rates down, and interest rates of reasonable levels remain the key to a sustainable recovery.

Those who oppose a more expansive monetary policy for 1983 argue that the economy is finally beginning to show signs of revival and that a more stimulative policy is therefore not needed. While recent economic indicators suggest that a recovery may be underway, or that the steady downward slide has been halted, there is no indication of a definitive upturn. Many of the same encouraging signs were evident during the first quarter of 1981, but by the last quarter the "recovery" had aborted and the economy resumed its decline.

We believe that unless the FED acts more forcefully to bring down interest rates, the current recovery will never gain enough momentum to get off the ground. As a result, we are more likely to follow the pattern of 1981—a few quarters of weak growth followed by further declines.

The present level of real interest rates represents the principal barrier to economic recovery. Real short term rates are still in the four to five percent range whereas in previous economic declines,

real short term rates were close to zero during the first year of recovery.

Historically high levels of real short-term interest rates have helped to perpetuate the high levels of real long-term rates which have had such a crippling effect on the rate of capital formation—there is no reason for an investor risk his funds in the long-term market when he can still get a high and virtually riskless rate of return in the short-term market. Long-term rates will not come down until short-term rates decline further, and short-term rates will not come down until the Federal Reserve takes steps to bring them down.

Last December, the Senate and ultimately the Congress approved an amendment to the Continuing Resolution declaring that it is the sense of the Congress that the Federal Reserve, with due regard for controlling inflation, "should continue to take such actions as are necessary to achieve and maintain a level of interest rates low enough to generate significant economic growth." (Sec. 160 of PL 97-377)

Despite this clear directive from the Congress, the Federal Reserve still appears to be focusing primarily on the monetary aggregates with little or no regard for the level of interest rates. In his appearance before the Committee, Chairman Volcker went so far as to assert that the Federal Reserve is powerless to reduce interest rates without reviving inflation.

The Federal Reserve's claim of powerlessness is not justified in our view. This is not to say there are no circumstances where a policy of reducing interest rates would not be inflationary. However, in our present situation, the danger of continued stagnation and high unemployment represents a far greater threat to the economy than the threat of inflation.

We are using only 67 percent of our industrial capacity, the lowest level since the 1930's. One worker out of ten is unemployed and millions more are under employed. At the same time, inflation has dropped sharply. Wholesale prices rose only 3.5 percent in 1982 and actually declined in January of 1983. Consumer prices rose less than 4 percent in 1982 and were declining by the end of the year. The increase in unit labor costs dropped sharply from 11 percent in the last quarter of 1981 to 3 percent in the last two quarters of 1982. (Many economists believe changes in unit labor costs are the best measure of the underlying rate of inflation in the economy.)

The principal argument against a more expansive monetary policy seems to be the fear of inflation. It is asserted that whenever the Federal Reserve begins to accelerate money growth to bring down interest rates, the market anticipates more inflation and that these expectations drive up interest rates and prices. A stimulative policy is therefore counter-productive.

Nonetheless, the Federal Reserve, in response to strong pressure from the Congress, was able to relax its tight grip on the money supply during the last half of 1982 without rekindling inflation or higher interest rates. Contrary to the conventional wisdom, prices and interest rates did not increase; instead, they fell. Short-term interest rates dropped about five percentage points while long-term rates fell by three percentage points. Consumer prices also dropped about five percentage points.

Chairman Volcker has argued that while interest rates came down in July and August of last year, they failed to decline any further during the remainder of the year despite extremely rapid money growth. The conclusion we are supposed to draw from this observation is that interest rates are relatively unaffected by monetary policy and are determined by factors outside the control of the Federal Reserve.

However, Chairman Volcker failed to mention that virtually all of the money growth in the last quarter of 1982 was absorbed by a sharp drop in velocity. The money supply, as defined by M-1, increased at an annual rate of 13.8 percent from the third quarter to the fourth quarter of 1982. During the same period, the velocity of M-1 declined at an annual rate of 10.7 percent. Thus the effective rate of money growth was only 3 percent. By this measure, monetary policy was not expansive in the fourth quarter, it was tight as the Chairman implicitly conceded.

On the basis of this evidence, we are not at all convinced the Federal Reserve is as powerless to effect further reductions in interest rates as Chairman Volcker claims. The interest rate reductions the FED did engineer in 1982 were certainly welcome news for the economy. The fact remains that reductions in inflation paralleled the reductions in short-term rates so that real short-term rates remained essentially constant. Further action by the Federal Reserve is urgently needed to reduce the *real* level of short-term rates.

The Fed has been paralyzed by the fear of reviving inflationary expectations. We are convinced this view is misguided. The real problem is not a surplus of inflationary expectations but a deficit in growth expectations. After 3½ years of stagnation, businessmen have come to believe in the permanence of no growth.

It makes little sense for a company to invest in new plant and equipment and hire more workers when there are no expectations that the investment can be repaid through increased sales? Workers should refrain from making major purchases when they have to worry that they may be out of a job in a few months? Entrepreneurs are reluctant to undertake new ventures when the prospect of sharply higher interest rates threatens to strangle them before they can even show a profit. There is no incentive for business expansion given the slow growth policy adopted by the Reagan Administration.

With the three to four percent growth projected in the President's Economic Report, it will take almost ten years just to use up all the idle industrial capacity that already exists. It is no wonder that the consumer confidence index maintained by the National Bureau of Economic Research reached an all time low of 57 at the end of 1982, down sharply from its January, 1980 level of 76.

In the last several years, economic policy has centered on changing inflationary expectations in order to curb inflation. The policy has been effective (at an unacceptably high cost), the time has now come to shift gears and focus instead on changing growth expectations in order to stimulate recovery. Given the underlying "growth pessimism" permeating the economy, there is little chance the slow-growth policies of the Reagan Administration, aided and abetted by the Federal Reserve, can possibly revive the economy from

its current slump. The most likely result of a slow growth policy is no growth as tight money stifles the recovery, just as it did in 1981.

In the last five recessions, the rate of real growth in the first four quarters of recovery averaged 6.5 percent, while real short term interest rates averaged zero percent, as indicated on the following table:

	Percent real GNP growth	Real short- term interest rates ¹
Recovery period (first 4 quarters of recovery following recession):		
54 III to 55 II.....	7.4	-0.7
58 II to 59 I.....	7.0	-0.1
61 I to 61 IV.....	6.5	1.3
71 I to 71 IV.....	4.8	-0.4
75 II to 76 I.....	6.7	-9.3
Average.....	6.5	0.0

¹ 90-day T-bill less GNP deflator.

These results did not happen entirely by accident. They were supported by fiscal and monetary policies carefully designed to promote growth and recovery. Likewise, the economy needs a more vigorous boost from monetary policy in 1983 if it is to gain enough momentum to reach the take-off stage. What is different about this recession, is that we have an Administration and a compliant Federal Reserve dedicated to the proposition that government can only make things worse.

We will never get this country moving again until we break out of our self-imposed ideological strait-jacket and begin to use government creatively to meet our national needs.

We therefore recommend that the Federal Reserve follow the mandate given it by the Congress in 1982 and take such actions as are necessary to achieve and maintain a level of interest rates low enough to generate significant economic growth in 1983. On the basis of previous recoveries, this means we should aim for a 6 to 7 percent real GNP growth rate rather than the 3 to 4 percent sought by the Reagan Administration and the Federal Reserve. If we are to follow a high-growth policy, real short-term rates should certainly not be permitted to rise, and in fact should be significantly reduced in order to spur the growth we need to put our country back to work.

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